
The International Monetary System

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Semester 1 - 2009-2010

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- Currency Terminology
 - History of the International Monetary System
 - Contemporary Currency Regimes
 - Emerging Markets and Regime Choices
 - The Birth of the Euro
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Currency Terminology

Foreign Currency Exchange Rate: The price of one country's currency in units of another currency or commodity.

Spot Exchange Rate: Quoted price for foreign exchange to be delivered at once or in two days.

Forward Rate: Quoted price for foreign exchange to be delivered at a specified date in the future.

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Currency Terminology

Forward Premium or Discount: Percentage difference between spot and forward exchange rates.

Devaluation of a Currency: Drop in foreign exchange value of a pegged currency.

Depreciation of a Currency: Drop in foreign exchange value of a floating currency.

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Currency Terminology

Soft, or Weak, Currency: Currency expected to devalue or depreciate.

Hard, or Strong, Currency: Currency expected to revalue or appreciate.

Eurocurrencies: Currencies of one country in another country's bank.

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History of the International Monetary System

The Gold Standard, 1876-1913

Rules of the game (for participating countries):

- I. Fix an official gold price and allow free convertibility between domestic money and gold at this official rate (US\$20.67/ounce of gold, £4.2474/ounce of gold).
- II. Impose no restrictions on the import and export of gold and its use for international transactions.
- III. Issue national currency only with gold backing.

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History of the International Monetary System

The Gold Standard, 1876-1913

Rules of the game (for participating countries):

- IV. In the event of a short-run liquidity crisis associated with gold outflows, the central bank should lend to domestic banks at higher interest rates.
- V. If Rule I is temporarily suspended, restore convertibility at the original rate as soon as practical.

The gold standard worked until World War I. The war disrupted trade flows and the free movement of gold.

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History of the International Monetary System

Example of the Gold Standard

Consider a world with two countries denoted A and B and suppose that Country A runs a balance of trade surplus, i.e. its exports exceed its imports.

Country A exports goods and imports gold. Its money supply increases, which increases the price of its goods and services. The reverse occurs in B

The increase in A 's prices and the decrease B 's prices will eventually correct the trade imbalance.

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History of the International Monetary System

Inter-War Years and World War II, 1914-1944

During WWI and the early 1920s, currencies fluctuated over a wide range of values, and this not in an equilibrating manner (speculation).

The U.S. adopted a modified gold standard in 1934 (\$35/ounce). Under this standard, the U.S. Treasury traded gold with central banks only, not private citizens.

After WWII, the U.S. dollar was the only major currency that continued to be convertible.

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History of the International Monetary System

Bretton Woods and the IMF, 1944

After WWII, Allied Powers met in Bretton Woods, New Hampshire.

A U.S. dollar-based international monetary system was then created, providing for two new institutions:

The International Monetary System (IMF), and

The World Bank.

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History of the International Monetary System

Role of the IMF

- Offer temporary assistance to member countries trying to defend their currencies.
- Assist countries having structural trade problems if they promise to take adequate steps to correct these problems.
- The **Special Drawing Right** is an international reserve asset created by the IMF to supplement existing foreign exchange reserves.

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History of the International Monetary System

Bretton Woods Agreement, Rules of the Game

- I. Fix the value of the domestic currency in terms of gold.
- II. Keep currency value within 1% of its par value in the short run but leave its long-run value open.
- III. Permit free convertibility for current account transactions but use capital controls to limit speculation.

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History of the International Monetary System

Bretton Woods Agreement, Rules of the Game

- IV. Offset short-run imbalances by the use of official reserves and IMF credits, and sterilize the impact of exchange market interventions on the domestic money supply.
- V. Permit national macroeconomic autonomy (price level and employment).

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History of the International Monetary System

Fixed Exchange Rates, 1945-1973

The Bretton Woods system evolved into a fixed-rate dollar standard.

The system eventually collapsed, due to diverging monetary and fiscal policies, differential rates of inflation and various external shocks.

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History of the International Monetary System

Fixed Exchange Rates, 1945-1973

The US\$ was the main reserve currency held by central banks.

Persistent deficits in the U.S. balance of payments had to be financed by heavy capital outflows of dollars.

Foreigners, having accumulated huge reserves of US\$, eventually lost confidence in the ability of the U.S. to convert dollars to gold.

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History of the International Monetary System

An Eclectic Currency Arrangement, 1973-Present

The dollar was devalued a first time in 1971, a second time in 1973 to eventually started floating.

Since 1973, the world has experienced more volatile exchange rates.

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History of the International Monetary System

World Currency Events

See Exhibit 2.2

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Contemporary Currency Regimes

The IMF classifies exchange rate regimes into eight categories:

- Exchange Agreements with No Separate Legal Tender (39 countries)
- Currency Board Arrangements (8 countries)
- Other Conventional Fixed Peg Arrangements (44)
- Pegged Exchange Rates within Horizontal Bands (6)
- Crawling Pegs (4)

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Contemporary Currency Regimes

IMF classification (continued):

- Exchange Rates within Crawling Pegs (5)
- Managed Floating with No Pre-Announced Path for the Exchange Rate (33)
- Independent Floating (47)

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Contemporary Currency Regimes

Fixed Versus Flexible Exchange Rates

Fixed rates provide stability in international prices.

Fixed rates are anti-inflationary.

Fixed rates necessitate central banks to maintain large quantities of international reserves.

Fixed rates may be maintained at levels inconsistent with economics fundamentals.

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Contemporary Currency Regimes

Attributes of the “Ideal” Currency

- Exchange rate stability
- Full financial integration
- Monetary independence

See Exhibit 2.3

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Emerging Markets and Regime Choices

- Currency Boards
- Dollarization

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The Birth of the Euro

- Timetable
- Convergence Criteria
- Why Unification?
- The Launch of the Euro
- Achieving Monetary Unification

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What Lies Ahead?

See Exhibit 2.7

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